VZCZCXRO3408
PP RUEHDBU RUEHPW RUEHSL
DE RUEHBUL #3471/01 3021258
ZNR UUUUU ZZH
P 291258Z OCT 09
FM AMEMBASSY KABUL
TO RUEHC/SECSTATE WASHDC PRIORITY 2660
INFO RUEATRS/DEPT OF TREASURY WASHINGTON DC 0926
RUCNAFG/AFGHANISTAN COLLECTIVE

UNCLAS SECTION 01 OF 02 KABUL 003471

DEPT FOR S/RAP, SCA/FO, SCA/RA, AND SCA/A
TREASURY FOR M. KAPLAN, A. WELLER AND J. CASAL

SENSITIVE
SIPDIS

E.O. 12958: N/A
TAGS: EFIN EAID PGOV PREL AF
SUBJECT: IMF BULLISH ON AFGHAN REFORM EFFORTS; WRAPS UP PROGRAM REVIEW

¶1. (SBU) Summary. At the urging of the Afghan Government and of the U.S. and other donors, the IMF rescheduled its previously canceled mission and traveled to Kabul to conduct the sixth review of Afghanistan's Poverty Reduction and Growth Facility (PRGF). The IMF mission's review of the program was favorable and team members expressed confidence the Fund and the Afghan Government will negotiate by mid 2010 a successor program entailing deeper financial and structural reforms. The IMF team also assessed Afghanistan's progress under the Highly Indebted Poor Countries (HIPC) Program and found implementation of the various "triggers" within the HIPC framework is progressing. The recommendation for "Completion Point" and full debt relief from the Paris Club debtors is expected sometime in early 2010.

¶2. (SBU) Reporting on the overall Afghan economy, the IMF mission found that GIRoA has exceeded the IMF's revenue collection target set last year due to stronger than expected revenue performance (almost entirely increased customs receipts). Nevertheless, revenue as a share of GDP remained unchanged at around 7 percent, extremely low even for least developed countries. IMF staff stated that they will likely adjust the revenue target upwards and press the Afghan Government to broaden and strengthen its tax base. The IMF also noted while banking sectors performance is satisfactory, it has rapidly expanded and should be monitored carefully. Improved banking supervision and stronger anti-corruption measures are necessary. End Summary.

¶3. (U) An IMF mission visited Kabul October 20-27 to review Afghanistan's Poverty Reduction and Growth Facility (PRGF) and to look as well at Afghanistan's progress in achieving the requirements ("triggers") under the Highly Indebted Poor Countries (HIPC) program. The team's visit was especially appreciated given its refusal in September to come to Afghanistan, a decision which produced sharp criticism from Finance Minister Zakhilwal as well as from donor governments.

INCREASING AFGHAN GOVERNMENT REVENUES

¶4. (SBU) In an October 26 meeting with Ambassador Eikenberry and senior Embassy officials, the IMF mission noted that compared to other low income countries, Afghanistan's current revenue performance -- collecting about 7% of GDP, or approximately $1.1 billion -- is significantly below average, even for post-conflict or least developed countries. The good news is that while revenue collection slowed in recent months due to political uncertainty surrounding the elections, revenue collections grew 40% increase during months 5 and 6 of the Afghan calendar year (August and September) over last year. Increased trade and customs receipts (particularly fuel duties), described by the IMF as "low hanging fruits," are largely responsible for the improved revenue picture. While good in the short-term, this change alone will not lead to long-term fiscal sustainability. The IMF noted the key is to increase quantitative targets in concert with qualitative reforms. The latter, according to the IMF mission, will place Afghanistan on a path toward sustainable increases in revenue -- potentially

achieving 15% of GDP in the next five to ten years. Even with these reforms, Afghanistan's fiscal situation will remain fragile over the next ten years given expansion of security forces and the need for increased spending in other areas.

¶5. (SBU) Fund staff emphasized the importance of sustaining long-term revenue potential by broadening the tax base, through expansion of the Large Tax Payer Office (LTO) and the Medium Tax Payer Office (MTO), and the eventual introduction of consumption-based taxes, such as a Value Added Tax. Moreover, long-term revenue improvements need to be structural. They will depend too on strengthening tax administration, developing Afghan customs, and curtailing corruption. The IMF stressed it will be critical for donors to align their positions and push for meaningful reforms during the next year as a part of a broader "reform framework" with the new administration.

IMPROVING THE BANKING SECTOR

¶6. (SBU) The banking sector in Afghanistan has grown rapidly over the past 5 years, which has generated concerns about its overall health. The IMF does not believe there is an imminent danger, but the extent to which the sector has expanded means donors -- and GIRoA -- should maintain a close watch. The IMF staff stated non-performing loans levels are manageable and the capital base within banks is acceptable. Over the coming years, however, Afghanistan will probably see some banks merge.

¶7. (SBU) Mission staff expressed concern that the commercial banking sector seems reluctant to lend to certain businesses. The IMF team said commercial banks still see loans to Afghan businesses as "too risky." Moving forward, the government will need to build up its

credit information bureau (now housed at the Central Bank) and collateral office so bankers can assess risk and better execute the function of lending. In addition, the Central Bank will need to strengthen its regulatory capability. Increased banking sector growth has led to concerns about governance within individual banks and the ability of supervisory authorities to keep pace. Until this situation improves, a lower lending rate could be beneficial from a regulatory standpoint.

OTHER KEY INDICATORS

¶8. (SBU) The IMF team also provided several points on Afghanistan's macroeconomic and fiscal sustainability:

--Economic growth. IMF staff now expects real GDP growth in 2009-10 of 15.7 percent. For 2010-11 the Fund forecasts 8.6 percent growth, slightly down from their earlier forecast of 9.0 percent.

--Revenues/GDP. The new revenue targets and GDP forecasts suggest a revenue/GDP target of 7.7 percent for 2009-10 (compared to an original program target of 7.3 percent).

--Inflation. Staff said interest rates are dropping and headline inflation is negative, with core (i.e., non-food) inflation almost flat. By contrast, Pakistan has 10-15% headline inflation.

--Reserves. This target was the only one missed, Staff said. Accumulated reserves fell short because of data audit problems and not GIRoA policy reasons.

TIMING GOING FORWARD

¶9. (SBU) Depending in part on political developments in the coming weeks, the IMF will complete its Sixth PRGF review in December and take the findings to the Board in January 2010. Despite a few outstanding triggers (e.g., pension reform and mining regulatory framework), the IMF and World Bank also expect to recommend HIPC completion point in January 2010. Following Board approval, the team plans to return to Afghanistan in January to discuss the 2010/2011 budget and begin negotiations on a new PRGF, which again will be a three year program. The IMF team mentioned negotiations for the new PRGF may be difficult, but this situation is to be

expected if more complex and meaningful reform measures are implemented. As a result, they envision a possible extension of the current PRGF through June to allow for new program discussions. The GIRoA strongly supports a new PRGF program that would help move the reform agenda forward. Formal negotiations for the new PRGF program will probably start in April 2010. The parameters of the reforms will focus on improving domestic revenue generation and fiscal management as well as on privatization of public enterprises. Each of the reform benchmarks will also include good governance and anti-corruption elements as well.

EIKENBERRY